

To: Basel II NPR Public File
From: Anna Lee Hewko
Date: October 12, 2006
Re: Summary of Meeting with ABN-Amro and Institute for International Bankers

Representatives of the Federal Reserve Board of Governors, the Office of the Comptroller of the Currency, the Office of Thrift Supervision (collectively, the agencies), ABN-Amro, and the Institute of International Bankers participated in a conference call on October 3, 2006 and discussed certain aspects of the interagency notice of proposed rulemaking (NPR) to implement a new risk-based capital framework based on the Basel II capital accord issued by the Basel Committee on Banking Supervision. Before the conference call, ABN-AMRO and the IIB submitted a document (attached) outlining various areas where the NPR differed from the European Union's Capital Requirements Directive (CRD), which implements the Basel II Framework in Europe.

The discussion generally focused on differences in the definition of default between the NPR and the CRD, which uses the definition of default in the Basel II capital accord. Industry representatives stated that they were concerned with the potential need to develop dual data systems to comply with the different rules outlined in the CRD and the NPR. Although the industry representatives conceded that developing dual systems would be possible, they suggested that doing so would be costly and could increase the likelihood of errors.

The industry representatives acknowledged that a bank could harmonize the two definitions in practice by placing exposures in non-accrual status whenever the bank determines that the obligor is unlikely to pay in full. However, because such a practice likely would lead to a large increase in the number of exposures placed in non-accrual status, the industry representatives expressed concern that supervisors may construe such a practice as manipulating LGD estimates by increasing the number of defaulted exposures for which no loss is incurred. The industry representatives indicated a preference for the CRD definition of default, but noted that their overriding concern was that the two definitions be harmonized.

Under the NPR, a wholesale obligor is in default if, for any wholesale exposure of the bank to the obligor, the bank has incurred a credit-related loss of 5 percent or more of the exposure's initial carrying value in connection with the sale of the exposure. The agencies asked whether this 5 percent standard was appropriate. While ABN-Amro expressed no opinion whether 5 percent was appropriate, they prefer a bright line test to the CRD standard of "material credit related loss." IIB noted that some of their member institutions have suggested that the 5 percent standard is too low.

With respect to differences between the retail definition of default under the NPR and the CRD, industry participants suggested that the practical differences between the

definitions could be reduced if the U.S. rules redefined retail default to include exposures that are placed in a non-accrual status.

The participants also discussed the effective 8 percent floor on LGD that the NPR imposes if an institution cannot estimate LGD under economic downturn conditions. The industry representatives suggested that the proposed floor was difficult to justify for certain exposures and that they preferred the CRD approach which permits an institution to build a margin of conservatism into LGD estimates where there is no economic downturn data. The agencies responded that the Basel II NPR provides a simple means to allow a bank to use the advanced internal ratings-based approach when it is unable to estimate LGD under economic downturn conditions, but that a bank could use its own estimates of LGD if it demonstrates that those estimates reliably and sufficiently reflect losses under economic downturn conditions.

List of Attendees

Agency Participants

Roger Tufts	OCC
Amrit Sekhon	OCC
Tommy Snow	OCC
Margot Schwadron	OCC
Fred Finke	OCC
Joseph Evers	OCC
Carl Kaminski	OCC
Grovetta Gardineer	OTS
Kevin Anderson	OTS
Karen Osterloh	OTS
Anna Lee Hewko	FRB
Paul Sternhagen	FRB

Industry Participants

Lawrence Uhlick	IIB
Richard Kaufman	IIB
Ken Bachman	IIB
Alexander Reeders	ABN-Amro
Paul Widuch	ABN-Amro
Shahzad Kazi	ABN-Amro



General	<p>Definition of default</p> <p>ANNEX VII Part 4: (44) A ‘default’ shall be considered to have occurred with regard to a particular obligor when either or both of the two following events has taken place:</p> <p>(A) The credit institution considers that the obligor is unlikely to pay its credit obligations to the credit institution, the parent undertaking or any of its subsidiaries in full, without recourse by the credit institution to actions such as realising security (if held).</p> <p>(B) The obligor is past due more than 90 days on any material credit obligation to the credit institution, the parent undertaking or any of its subsidiaries. Exemptions to the 90 days are possible for certain types of exposure and subject to national discretion</p>	<p>(1) Retail (i) A retail exposure is in default if:</p> <p>(A) The exposure is 180 days past due, in the case of a residential mortgage or revolving exposure;</p> <p>(B) The exposure is 120 days past due, in the case of all other retail exposures or;</p> <p>(C) The bank has taken a full or partial charge-off or write down of principal on the exposure for credit-related reasons</p> <p>(2) Wholesale. (i) A bank’s obligor is in default if, for any wholesale exposure of the bank to the obligor, the bank has:</p> <p>(A) Placed the exposure on non-accrual status consistent with the Call Report Instructions or the TFR and the TFR Instructions Manual;</p> <p>(B) Taken a full or partial charge-off or write-down on the exposure due to the distressed financial condition of the obligor; or</p> <p>(C) Incurred a credit-related loss of 5 percent or more of the exposure’s initial carrying value in connection with the sale of the exposure or the transfer of the exposure to the held-for-sale, available-for-</p>	<p>High . Under US definition, expected are lower PDs, higher LGDs, and a higher presumed impact of pre-default forced reimbursement. In case banks must use for host supervisory purposes another definition than used for consolidated group and internal purposes, compliance with the one obligor, one rating requirement and with internal and syndicated cross default provisions will occur. In addition, there will be issues in the area of cross border rating validation, use test, mapping to external ratings and, for some banks, in the setting of correlation parameters</p>
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General	Supervisory mapping function	Not replicated, but insistence on stressed/downturn LGDs	In case banks are not able to provide own ELGD estimates (downturn), an imposed supervisory mapping function must be used de facto leading to a minimum LGD of 8%	Expected that the effect of the mapping function on capital requirements will be minimal after Pillar 2 in non-US banks. Especially for daily revalued, but not daily re-margined financial collateral, this function is rather conservative for back to back facilities, this is overly conservative as cash collateral is not impacted by downturn conditions. Banks may have negative correlation between PDs and LGD
General	Prompt Corrective Action-leverage ratio	Not replicated, but de facto in some EU member states bilateral agreements leading to equivalent requirements	PCA - leverage ratios	Further research required
General	Scope of Application	Includes investment banks	Investment banks fall under SEC rules; unclear whether those will be a carbon copy of NPR	TBD
General	Treatment of immaterial portfolios	Application of the standardised approach	Application of a 100% risk weight	In conformity with QIS3 and 5 outcomes this leads to a considerable difference in favour of US banks
General	Treatment of SME	Group turnover < EUR 50 mln, correlation adjusted in RWA formula		Potentially high depending on a bank's portfolio composition
General	Defaulted assets	Risk weighting using the highest of the original LGD or Elbe, i.e. the best estimate of expected loss for the defaulted exposure.	Newly introduced RWA calculation for defaulted assets effectively ensuring that the RWA result for defaulted assets can never be lower than RWA pre-default.	Besides the fact that compared to the CRD this calculation applies to a different group of assets given the divergence in the definition of default, two additional things strike us about this calculation: 1. the floor seems to penalise intermediary downgrades prior to default, and 2. upon default suddenly collateral recognition is disallowed. Whether these two latter effects were unintended or not, the CRD stipulations are very different and it leads to a totally different practice.



General	Treatment of insurance subsidiaries	Deduction of investment amount	deduction of insurance capital requirement (US: 200% of Authorized Control Level)	Further research required
General	History requirements	Relaxed: initially required 2 years for PD, LGD, and EAD and ultimately increasing to 5 yrs, but this is subject to national discretion	5 for PD and 7 years for LGD and EAD	Varies strongly between EU countries whereby some EU regulators indeed will be very lenient and other require even more history than required in the NPR/ Basel II framework
General	Double default	No prior permission required	May only be used if given permission	Probably low. Given that the double default treatment is already rather limitative and that the formula is straightforward, we do not understand why prior permission must be given.
General	Rating assignment process	Stipulations on overwrites	Judgmental adjustments in quantification process	It is unclear whether the judgmental adjustments cited in the NPR contain adjustments in the rating model inputs (judgmental parameters used in rating model), or post-rating model adjustments (i.e. overwrites) or both. In any event, provided the overwrite process' integrity is ensured, overwrites may be seen as proof of a use test compliance and certainty that rating model are not part of a fully automated process managed entirely outside the scope of the business.
General	Capital ratios	8% regulatory capital plus/minus deduction items (4% requirements was part of Basel I)	8% tier 1 and tier 2, 4% tier 1	To be verified by European Commission
General	Treatment of public sector entities/ governmental entities	List of public sector entities or criteria published per EU memberstate prescribing treatment as sovereign or bank. (or even implicitly, as corporate)	No specific guidance is provided other than that it is categorized as a wholesale exposure	To be verified
General	Transitional floors	95 - 90 - 80% for 1st, 2nd and 3rd floor period	95 - 90 - 85% for 1st, 2nd, and 3rd floor period (floors deleted on a bank by bank basis)	Given later implementation in the US, potentially high



General	Minimum Risk based capital ratio requirements	8% total qualifying capital.	4% Tier 1 8% total qualifying capital. Tier 1 capital must be at least 50% of total qualifying capital	More research required on notion of capital and on capital deduction items as well as on impact of accounting standards
General	Expected loss amount	ELbe	Impairment estimate	Expected to be similar
Asset Sec	Asset Securitisation: definition	No definition given on asset securitisation, but implicitly limited to traditional securitisation and synthetic securitisation; for traditional securitisation, the transferee must be a securitisation SPE, for synthetic, the condition that risk transfer must be by way of tranching cover is not included	Any transaction that involves the tranching of credit risk; tranching credit protection must be on wholesale exposures	Unknown, potentially high
Asset Sec	Asset Securitisation: securitised asset types	No limitation on securitised asset types	For the full securitisation treatment to apply, solely financial assets can be securitised assets (i.e. no music concert and film receivables). For non-financial assets, the RBA may apply but if not rated or no inferred rating available, then capital deduction	Expected to be minimal
Asset Sec	Asset Securitisation: Deduction	In such a case the bank must deduct the exposure from capital or apply a 1250% risk weight	If the exposure does not qualify for the RBA, IAA or SFA, the bank must deduct the exposure from total capital	In view of tax effects the difference is not neutral. Note: art. 57 of the CRD r seems to contradict this flexibility
Asset Sec	Asset Securitisation: interest only MBS		Risk weight equal or above 100%	Further research required
Asset Sec	Asset Securitisation: liquidity facility to ABCP	Different CCFs depending on the type of liquidity facility	Risk weighted is amount that could be drawn given assets currently held by program	In most circumstances the effect will be neutral
Asset Sec	Asset Securitisation: minimum number of external ratings		For originating bank: min. = 2	Expected to be minimal as common practice to have at least 2 rating agencies involved



Asset Sec	Asset Securitisation: RBA risk weight super senior tranche	Special 6% risk weight for super senior tranches; next senior tranche will be risk weighted at 7%. This is however at national discretion	7%	High
Asset Sec	Asset Securitisation: haircut determination	The IRB rules on CRM must be adhered to A+	65 day holding period for haircut determination in case of CRM in asset securitisation	further research is required on funded synthetic securitisations
Asset Sec	Asset Securitisation: significant risk transfer	National discretion, different criteria are used to determine if significant risk has been transferred	For traditional securitisation, follows US GAAP	Unknown
Asset Sec	Asset Securitisation: MBS		MBS / participation in a certificate resulting from mortgage loan swap with recourse: separation of 2 exposures	Unclear stipulation
Asset Sec	Asset securitisation: IAA	Not explicitly stated	All or nothing principle: to be applied consistently on ABCP related exposures	In case of re-securitisation of ABS through conduits, banks prefer to apply RBA
Asset Sec	Asset Securitisation: third party CDS provider		Even if non-eligible securitisation for originator, a bank acting as credit protection provider must use the securitisation treatment	Unknown
Asset Sec	Asset Securitisation gain on sale		Deduction from capital of after tax gain on sale and of any portion of CEIO	To be verified
Asset Sec	Asset Securitisation: N		If notional amount of underlying exposures = 25 or if underlying exposures are retail exposures, then N = 6	low
Asset Sec	Asset Securitisation: use of external ratings	In case more than 2 ratings, the second worst must apply	In case more than one external/ inferred rating, always use worst	High



Asset Sec	Asset Securitisation: eligible disruption liquidity facility under the SFA	CCF = 20%	Considered not to apply this provision	More research required; potentially high
Asset Sec	Asset Securitisation: servicer cash advance facility	If eligible, RW = 0%; otherwise nominal amount	Undrawn not taken into account	Neutral? Further research required
Covered bonds	Covered bonds	Special treatment (but directed at Standardised and Foundation approach)		Advanced EU banks might require equivalent treatment under advanced approach given that this is a LDP
CRM	CRM: Guarantees - min. requirements	unconditional guarantees allowed, subject to national discretion. Must be validated though.	Conditional guarantees not allowed	High as credit insurance often is conditional (except comprehensive cover); however, validation will prove hard.
CRM	CRM: LGD - eligibility of collateral	Internal requirements must be generally consistent with those established for the Foundation approach in Annex VIII. Regulators translate this into that the internal policies must yield the same effect. The result is that banks must implement many costly processes for this purpose. No clarity given leading to a bank by bank or country by country approach.	Hardly any operational and eligibility criteria for non-financial collateral	High
CRM	CRM: Financial collateral	Minimum rating requirements on issuers of debt securities (exc. Sovereigns); equity must be traded on a recognised exchange; forex haircut = 11.3%; haircut for investments in funds: weighted average haircut if known investments, otherwise highest haircut	Equity must be traded; forex haircut is 8%; highest collateral haircut for investments in funds	High as margins in this type of business are often thin



CRM	CRM: Non-Financial collateral	Many operational and eligibility criteria (pages long); in addition minimum collateralisation values depending on collateral type		High for EU banks as the CRD requirements are not always contained in internal practices and imply high extra overhead costs
CRM	CRM: Unfunded credit protection – eligibility of protection providers (PD substitution)	Min. rating requirements for corporate guarantors; ineligible are banks not subject to equivalent supervision		High, especially since double default is limitative
CRM	CRM: Unfunded credit protection PD substitution		Distinction between first demand guarantees or non-first demand guarantees	Estimated to be low
CRM	CRM: PD substitution lower risk weightboundary	Unfunded credit protection may be recognised by adjusting PD and /or LGD but not such that the adjusted risk weight would be lower than a comparable, direct exposure to the guarantor	The lowest of the PDs and of the LGDs may be used as long as the guarantee is payable on first demand; no lower risk weight boundary	Potentially considerable
CRM	CRM: Treatment of unfunded credit protection	Choice between treatment through LGD or PD on a bank portfolio basis.	Use of PD substitution, LGD substitution or Double Default may be determined on an exposure by exposure basis	TBD
CRM	CRM: Double default formula	LGD is the LGD of a comparable direct exposure to the protection provider; M is not specified but by implication is M of the exposure	LGD is the lower of LGD (unhedged exposure) and LGD (guarantee). Introduction of ELGD in formula; M = effective maturity of the guarantee	TBD
EAD	EAD asset based lending		Effect of pre-default paydowns is recognised	High provided banks can validate this by their history
EAD	EAD definition	Exposure value gross of value adjustments; correction in Expected Loss for value adjustments, provisions and discounts; no mention of accruals	Carrying value plus accruals minus transfer risk reserve	Minimal unless EL +/- provisions and value adjustments leads to a positive amount (accruals are included by most banks on their own accord)



EAD	EAD floor	EAD cannot be less than current outstanding	for certain types of exposures, pre-default paybacks may be taken into account; no floor.	potentially high as the history of some banks indicate that exposure is considerably less than in the period leading up to default, this due to good risk management practice. The CRD text is therefore unduly penalizing.
Equity	Equity: Treatment of investments in funds	CIU treatment: If a bank does not meet certain criteria OR is not aware of ALL of the underlying exposures, the bank shall look through to underlying exposures and apply SRW to all exposures irrespective whether this is an equity fund or another type of fund Alternatively, the institution may calculate themselves using IRB OR by third party making use of Standardised approach	Three alternative approaches: full look-through approach, simple modified look-through approach or alternative modified look-through approach. Minimum rating of 7%	The approaches show similarities; The CRD seems most conservative by requiring usage of equity SRW approach in many cases. Expected is that the CRD risk weights will in most cases be substantially higher than the min. 7% risk weight of the NPR. Although there is conceptually not much wrong with the proposed treatments, the process is rather cumbersome for banks, especially if not owner/manager of the funds in question
Equity	Equity: approaches	SRW, PD/LGD or IMM approaches	IMA or SRWA approaches	Potentially high as PD/LGD approach has specific stipulations for (defacto) strategic investments (adjusted imposed PD)
Equity	Equity: SRW risk weights	190% diversified private equity, 290% exchange traded; remainder 370%; (in addition EL = 0.8% x book value for diversified private and exchange traded, and 2.4% x book value for remainder)	300% or 400% for exchange traded and private equity ; no ECL calculation	To be decided
Equity	Equity: internal model method	No cherry picking, defined per pre-specified portfolio	All or nothing principle; apply to all private equity exposures or to none	Potentially high
Equity	Equity amount	Book value depending on prevailing accounting rules	Carrying value minus unrealized gains that are excluded from bank's capital	Further research required
Equity	Equity Investments: 'non significance'	100% risk weight, but solely allowed to banks whose aggregate equity exposures do not exceed 10% of tier 1 and tier 2 capital	100% risk weight: allowed up to 10 % of tier 1 and tier 2 capital; some equity exposures do not count in the aggregate value of equity exposures	Huge for banks active in the venture capital markets. Interpretation of NPR to be verified!
Equity	Equity floors/ calculation under IMA	floor calculated on an individual exposure level; floors set at respectively 192% and 208%	floor applied on a portfolio level; floor set 200/300%	High since it is hard/impossible to individualize VaR outcomes per exposure without losing portfolio effects



Equity	Equity hedge formula		Hedge effectiveness formula	Unknown
Equity	Equity derivatives	Treated under equity treatment	Treatment as wholesale exposure and derivative exposure, to be summed up	Further research required. Expected: minimal
Equity	Equity: Application of equity approach	Applies to corporate investments; financial investments up to 10% stakes	Applies to financial investments only; investments in financial subsidiaries are deducted from capital	Potentially high; Max RW of 400% versus 1250%
Equity	Equity grandfathering rule	Subject to national discretion, standardised approach to equity is allowed up to 2017 (100/150% RW)		High. Leads to unlevel playing field
Intragroup	Treatment of intragroup exposures	Special treatment, with exemption only possible within the home Member State. Standardised approach to be applied with risk weights ranging from 20% to 100%		Huge for EU network banks. Major issue for bank's internal asset and liability management
Lease	Lease	EAD based on discounted minimum lease payments defined by bringing in the concept of bargain option; special residual value formula ; specific treatment for property lease	Net investment in wholesale lease to be treated as single exposure to lessee. No separate risk weighting of lease residual. Retail lease: residual value is value of risk weighted asset	Further research into combined effect of applicable accounting standards and regulatory capital treatment required
LGD	LGD floor	Not replicated but insistence on downturn/stressed LGDs	Indicates that LGD must be at least equal to ELGD.	The paper by the Basel Committee seems to allow making use of a negative correlation between PD and LGD; banks in question will conduct further research on this phenomenon. Expected that the effect of the mapping function on capital requirements will be minimal after Pillar 2 of non-US banks in other G-10 countries.
Pillar 2	Pillar 2 minimum risk coverage	List contains more mandatory risk categories; EU regulators have added other mandatory categories	Market risk, credit risk, IRR in the banking book, OpRisk, liquidity risk, concentration risk, reputational risk, strategic risk. Concept of materiality introduced.	NPR gives less room for a tick box exercise as it stipulates that the internal approach should encompass all material risks a bank is exposed to



Retail	Retail: ineligible retail guarantees		Allows ineligible guarantee on retail exposures provided by wholesale guarantors to be treated as direct exposures on these guarantors; alternative considered is the instauration of a floor	
Retail	Retail segmentation		In general, retail segments should not cross national jurisdictions	It cannot be excluded that in the future in certain Asian countries retail segments cover portfolios in more than one country. In this sense, the statement limits flexibility and good business practice of banks.
Retail	Retail: seasoning effects		Seasoning effects, if deemed material, must be taken into account in retail PD	Creation of a rather challenging additional validation layer for US banks
Retail	Retail definition – inclusion of consumer loans	Personal mortgage loans excluded	All consumer loans excluded if legal entity is natural person	Varies per bank/ country
Retail	Retail threshold amount	EUR 1 mln	USD 1 mln	Depends on EUR-USD exchange rate
Specialised Lending	Specialised lending	The CRD implemented one approach for all specialised lending exposures and did not replicate the slotting criteria, but specifies 7 main criteria. The special treatment for HVCRE is not included	Different specialised lending classes with adjusted correlations for HVCRE	Depend on usage of HVCRE. EU's view was that a special treatment was not warranted in the EU context
Traded Products	EPE Usage of models	Implementation per legal entity	More flexibility in implementation: product by product. Alternative methodologies for certain product types allowed provided conservative	The CRD requirement proves impossible to meet as some structured derivatives can never be modeled under EPE methodology. Should be replaced by implementation per traded product type and a principle based requirement that cherry picking is not allowed and that a well founded implementation plan is submitted to regulators.



Traded Products	VaR haircut approach for repo style transactions (under PFE + add on methodology)	Limited to repo style transactions	Extended to margin loans	Further research required; not clear how many banks will have implemented this VaR approach to haircuts
Traded Products	Maturity exemption – examples	The CRD has not copied in the list provided in the Trading Book Review of the Basel Committee; the latter's list did not specify sovereign exposures as an allowed exemption. The CRD makes this a national discretion.	Listed examples that may be put under the exemption rule include sovereign exposures	Depends on supervisor. Expected is that supervisors will be less inclined to accept types of exposures not mentioned in the Trading Book Review example list. Banks view is that roll-over risk is grossly overrated since downgrades definitely lead to banks refusing to renew exposures
Traded Products	EPE Operational and eligibility requirements	Long, prescriptive list.	Same requirements, but a less extensive and detailed list giving banks more flexibility to develop their own methodology/ model	CRD requirements potentially hinder EPE modelling if not implemented taking substance over form approach
EL	Expected loss treatment	EL set off against provisions discounts and value adjustments. Assumed is that provisions includes specific provisions.	ECL set off against eligible credit reserves (all general allowances). Not included are allocated transfer risk reserves and other specific reserves.	This follows from the difference in the definition of EAD. Further research required to investigate that end result is indeed neutral in all cases. N.B. shortfall/ excess amounts are expected to be different given differences in provisioning practices and accounting treatments